Finance, business models and regulation

n the stupefying volume of commentary on the financial crisis, some ele-

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mentary questions are not just unanswered but unasked. Since these have serious implications for evaluating proposals for increased

bailouts and regulation, they darn well better be asked.

The key question is this: Given that the forces of globalization and technology are undermining business models of many kinds, is the crisis due to the fact that the business models of some of the largest financial institutions have become unworkable?

If so, this would explain much of the hysteria. When a crumbling business model causes a public crisis, the instinct of the affected firms is to use the turmoil to get the government, first, to bail them out, and, second, to protect the model, often by crippling rising competitors that are better adapted to the new realities.

cal Economy of the Securities Act of 1933," Professor Paul Mahoney demonstrated that the

New Deal reforms were in part a tool for the toptier New York investment banks to suppress competition developing

out in the hinterland. The successful pressure five years ago by much of the financial community to force companies to treat stock option grants as an expense can be interpreted as an attack by conventional financiers against the new and uppity venture firms that were taking over the tech business.

So, is this familiar pattern being repeated, and the financial crisis serving as an excuse to regulate all the bystanders, to the benefit of the guilty financial institutions?

A good starting point is to ask: Why did the great financial institutions get so heavily involved in residential real estate? Recalling the origin of Fan-

nie and Freddie, one rationale was that investment capital did not go into housing because the housing industry was too messy and finfocused on industrial investment. Something was needed that would allow residential construction to compete for money on a par with other industries. After all, if General Motors can get financing to produce consumer durables, why shouldn't Toll Brothers?

This is a fair enough theory, and the system worked pretty well for a long time, then suddenly, in the last few years, it went haywire, as the financial institutions piled into housing.

A possible explanation is that the combination of massive government favoritism for housing via subsidies and tax breaks made the area so lucrative that housing out-competed other sectors for capital, and the financial institutions responded, but that does not explain the explosion of the last half-decade.

Also arguing against the thesis that this was simply a response to rational profit opportunities is the reality that when risk is taken into account, the high profits were ephemeral. The Financial Times recently noted that new accounting rules could force banks to bring \$5 trillion to \$10 trillion back onto their balance sheets. This means the banks were guaranteeing the stuff, and if this is true, then the clients knew the stuff was risky, which

means the banks must also have known it.

So let us try an alternative hypothesis, which is that the financial institutions were pushed into real estate by competitive forces rather than pulled by extraordinary profit opportunities. In this view, the new financial

and the private pools called hedge funds are superior sources of funding for most industries. They are able to contribute rationalizing expertise and to avoid many of the massive organizational inefficiencies imposed on public companies every time Congress turns into a panicky mob.

Also, there are profound but only dimly understood consequences of the fact that the crucial form of capital is, increasingly, intellectual. Creative forms of corporate organization are needed to keep intangible and tangible capital meshing smoothly, something the new institutions can deal with more effectively than can the old.

So maybe the financial institutions got into trouble because their longstanding business model of funding industrial America came under pressure, and people whose business models come under pressure run risks. Casting about for replacements, they hit upon the residential housing area, and then, in the words of financial writer Andy Kessler, "[they broke] Wall Street's unwritten 'sausage' rule that you sell this stuff to clients. but never own it yourself.

If this is the case, then the financial institutions need to develop new lines of work, and good luck to them. But the last thing needed is a regulatory overreaction directed at shoring up broken business models while crippling new and better ones. We don't regulate Craig's List to help newspapers, and the complexity of the financial world should not provide a cover for doing the equivalent there. The creative destruction of Schumpeterian capitalism is at work, so let it rip.

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